

FEDERAL RESERVE CREDIT POLICY

1951 TO 1959

A Thesis

Presented to

The Graduate Division

Drake University

In Partial Fulfillment

of the Requirements for the Degree

Master of Arts

by

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August 1960

1960
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104

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CHAPTER I

INTRODUCTION

One of the major problems in the American economy has been the expansions and contractions of business cycles. The Federal Reserve System has as one of its major objectives the reduction of the excesses of business cycles through stabilization. The original purpose of the Federal Reserve System as stated in the preamble to the Federal Reserve Act was:

To provide for the establishment of Federal Reserve Banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.¹

Since 1913, additional powers granted to the Federal Reserve System by Congress have indicated that the System's main purpose is facilitating economic growth and stability. It has the power, through its credit policy, to influence the supply of money and credit towards that objective.

I. THE PROBLEM

Statement of the problem. The purpose of this study was to determine (1) the criteria for the credit policy of the Federal Reserve System; (2) the means by which the credit policy is implemented; and (3) the actual credit policy in effect from 1951 to 1959.

¹Forty-Five Years of the Federal Reserve Act (Philadelphia: Federal Reserve Bank of Philadelphia, 1958), p. 4.

Importance of the study. The credit policy of the Federal Reserve System for previous years has been reviewed by many authors. Hardy¹ discussed the years from 1922 to 1931. Several books on Money and Banking examine the credit policy from the establishment of the Federal Reserve System in 1913 to the early 1950's. Fforde studied the Federal Reserve System from 1945 to 1949.² This thesis brings the history of the credit policy up to date.

The starting date of this study is March 4, 1951 which was the date of the Accord between the Board of Governors of the Federal Reserve System and the Treasury. The Accord marked a change in policy since it was agreed that the Federal Reserve would no longer support long-term Government bonds at a 2½% rate of interest, as had been done since early in World War II.³ This change enabled the Federal Reserve to establish a more effective credit policy.

II. ORGANIZATION AND SCOPE OF THE THESIS

Chapter II of this thesis discusses the various criteria which have been used or proposed to formulate the credit policy of the Federal Reserve System. These criteria include the reserve ratio, maintenance of sound credit conditions, price level stabilization, and the interest

¹Charles O. Hardy, Credit Policies of the Federal Reserve System (Washington: The Brookings Institution, 1932).

²J. S. Fforde, The Federal Reserve System 1945-1949 (London: The Clarendon Press, 1954).

³Raymond P. Kent, Money and Banking (third edition; New York: Rinehart and Company, Inc., 1957), pp. 565-75.

rate. Chapter II also gives an explanation of the techniques used to carry out the credit policy. The primary tools which the Federal Reserve System uses to implement credit policy are changes in reserve requirements, changes in discount rates, and open market operations.

Chapter III of this thesis examines the record of Federal Reserve System action from the Accord in 1951 to the end of 1959. It explains how credit policy was determined and how the tools of credit policy were used during that period.

Chapter IV presents a summary and the conclusions derived from the study.

III. CONDUCT OF THE STUDY

In conducting the study, an examination was made of the economic theory pertaining to Federal Reserve credit policy. Material for this portion was obtained mainly from books on Money and Banking and economic theory supplemented by use of material published by the Board of Governors of the Federal Reserve System and the Federal Reserve Banks. The second phase of the study consisted of examining the day-to-day actions of the Board of Governors in determining policy and carrying it out. The primary sources for this phase were the Annual Reports of the Board of Governors of the Federal Reserve System.

CHAPTER II

CRITERIA FOR CREDIT POLICY AND TECHNIQUES OF CONTROL

Credit policy refers to the influence that the Federal Reserve System exerts on the volume of credit, its cost, the kinds of businesses that are financed, and the types of instruments that are used.¹ This chapter points out the criteria that have been used or proposed to determine a credit policy, and the techniques that are used to put that policy into effect.

I. CRITERIA FOR CREDIT POLICY

Reserve ratio. The earliest guide to a credit policy by the Federal Reserve System was the reserve ratio. This is the ratio of gold or gold certificates to the net liabilities of the central banks. The Federal Reserve Banks are required by law to keep a percentage of their assets in gold, or gold certificates since 1933, as a reserve against their notes and deposits. Originally this percentage was 40% against their notes and 35% against deposits. Since 1945 the Banks have been required to keep a reserve of only 25% against both notes and deposits.²

The use of reserve ratios to guide credit policy grew out of the functioning of the "automatic" gold standard. In the absence of a

¹Hardy, op. cit., p. 6.

²Eugene S. Klise, Money and Banking (Cincinnati: South-Western Publishing Company, 1955), pp. 252-3.

central bank, an outflow of gold was a reduction in the money supply of the country. This forced banks to reduce their loans and tighten credit. An inflow of gold increased the total money in the country and caused a lowering of interest rates and a condition of monetary ease.¹

With the Federal Reserve System, early credit policy was based on maintaining the automatic features of the gold standard. As Thomas states:

Before World War I, central bank policy seems largely to have been a reflection of the ebb and flow of the country's gold supply. The changes in the reserve ratio of the central banks were necessarily the most important consideration in determining credit policy. Any sustained loss of gold was the signal for restrictive measures, whereas an increase in the gold supply indicated the propriety of some expansion. Such a policy was required, if an international gold standard was to function effectively.²

The Federal Reserve Banks could disrupt this functioning if they felt the movement of gold was temporary or seasonal.³

The abandonment of the reserve ratio as a credit policy criteria came as a result of the large inflow of gold during the 1920's. This occurred while most countries were off the gold standard. When the reserve ratio reached 79.2% in July of 1922, the Federal Reserve Banks instituted a practice of issuing gold certificates for circulation, rather than using them as a base for note and deposit expansion.⁴ With the reserve ratio so far above the minimum, the gold stock could be used

¹Hardy, op. cit., p. 11.

²Rollin G. Thomas, Our Modern Banking and Monetary System (second edition; New York: Prentice-Hall, Inc., 1950), p. 378.

³Hardy, op. cit., p. 12.

⁴Thomas, op. cit., p. 380.

as a base for a large monetary expansion, but a monetary contraction could not be forced until there was a huge outflow of gold. The reserve ratio, therefore, became meaningless as a guide to credit policy. With the breakdown of the reserve ratio, the Federal Reserve Banks began to use other factors as criteria of credit policy.

Maintenance of sound credit conditions. The failure of the reserve ratio as a standard of credit policy led the Federal Reserve System to seek a more practical guide. The new policy criterion was maintenance of sound credit conditions. This policy was effected by making Federal Reserve credit available only to short-term needs of business and agriculture. As Thomas points out, the rules of policy the Federal Reserve Board adopted in 1923 were:

Federal Reserve credit should be utilized for accommodating productive activities but not for financing speculative or investment operations. Not only should reserve bank credit be used exclusively for productive purposes, but its use should be so restrictive as to be commensurate with increases in national productivity. Tests for determining whether or not reserve bank credit is being put to productive use should include:

- (a) Is credit being used to hold goods for speculative increases in prices?
- (b) Are goods moving smoothly from producer to ultimate consumer without speculative interference?
- (c) Does consumption keep up with the volume of trade, production, and employment?¹

This standard of credit policy is based on the commercial loan or real-bills theory of banking. This theory states "that the amount of credit would be properly adjusted to the requirements of the economy if bank loans were made only to supply working capital for business."²

¹Thomas, op. cit., p. 382.

²Klise, op. cit., p. 206.

The practice of making loans only for working capital was intended to provide an automatic credit policy. When banks supply funds only for working capital, it assures that an increase of goods is moving to the market. Thus, the supply of money is at all times proportionate to the needs of commerce. The prohibition against making loans for fixed capital prevents an increase in the supply of money when there are no additional consumer goods produced.¹

Actually, use of the commercial loan theory does not insure that the proper amount of credit is being supplied. As goods move to the market, there may be more than one loan existing simultaneously on the same goods. The manufacturer might obtain a loan against a stock of finished goods and before the loan is repaid might sell the goods to a wholesaler who also might obtain a loan to carry the same goods in his inventory. If this occurred, an excessive amount of credit would be extended. Secondly, making loans only for working capital does not prevent the money from being used for other purposes. A manufacturer might secure loans nominally for working capital, but actually to release his own funds for increasing his plant and equipment.²

Price level stabilization. Another criterion which has been advocated is stabilization of the price level. This standard is based on the quantity theory of money, which may be expressed in the formula $MV = PT$, where M is the quantity of money in circulation, V is the

¹Ibid., p. 309.

²Ibid., pp. 309-11.

velocity of money, P is the price level, and T the level of transactions.

Under this theory, the Federal Reserve System would vary the amount of money in circulation by expanding and contracting credit to keep the price level stable. During an expansion, when prices would normally rise, a decrease in credit would serve to restore the price level. During a depression, an increase in Federal Reserve credit would help to raise prices.

The objections of the Federal Reserve Board to the price stabilization standard have been pointed out by Goldenweiser:

The System has opposed such a formulation on the grounds (1) that prices are only one of the elements in the economy that should be stable; (2) that the System does not have complete control of the money supply, since it can only make additional lending by banks possible but cannot make the banks lend or the public borrow more than it wishes; (3) that the relationship between the supply of money and the price level is uncertain, since the rate of turnover of money is an equally potent factor, and the System has little influence on the turnover; and (4) that price changes come too late in the sequence of economic events, so that they signalize the existence of maladjustments after they have occurred.¹

Despite these objections there has been considerable agitation to make price stabilization the chief goal of Federal Reserve credit policy. In 1926 and 1927, bills were introduced which would make a price stabilization goal a matter of law.² In hearings during 1937-39, the same proposals came up, but the Federal Reserve System emphatically

¹E. A. Goldenweiser, American Monetary Policy (New York: McGraw-Hill Book Company, 1951), p. 74.

²Hardy, op. cit., pp. 201-2.

opposed any legislative change requiring price stabilization.¹

The interest rate. There are many advocates of the interest rate as a guide to Federal Reserve credit policy, for different reasons. One group wishes a low rate of interest to support the price of Treasury bonds. Another school seeks a perpetual low interest rate to encourage investment in a stagnant economy. A third group wishes fluctuating interest rates as a method of stabilizing business.

The Treasury Department has an objective of holding down the interest cost of the public debt. This problem becomes more acute when the Treasury is attempting to float large issues of bonds to finance war expenditures. The Federal Reserve System supported the Treasury in maintaining low interest rates by holding Government bond prices at or near par from 1942 to 1951.²

One group of monetary theorists holds that there should be a perpetually low rate of interest. This view gained ground during the 1930's when it was feared our major economic problem would be avoiding chronic depression. With a low rate of interest, they claimed, businessmen would be encouraged to borrow for expansion of plant and equipment. Also, there would be no reason for holding uninvested funds in the hope

¹Lloyd W. Mints, A History of Banking Theory in Great Britain and the United States (Chicago: University of Chicago Press, 1945), pp. 273-4.

²The New York Clearing House Association, The Federal Reserve Re-examined (New York: The New York Clearing House Association, 1953), pp. 15-6.

of obtaining higher interest rates.¹

The use of changes in interest rates can be a method of monetary control. A rise in interest rates during an expansion tends to reduce borrowing, thus acting as a damper. During a depression, low interest rates tend to stimulate borrowing. Critics of this method claim that the rate of interest has little effect on borrowing plans, and that during an expansion high interest rates fail to stop speculators, the group that should especially be controlled.²

The method of obtaining changes in interest rates is by expanding or contracting the money supply. Central banks have the power to change the money supply, but they have little power to change the demand for money. Businessmen borrow when they can make a profit in doing so. This occurs when the expected rate of return through the purchase of a capital asset is above the interest rate. During a depression, the expected rate of return is low or may actually be negative. Therefore, the demand for money is relatively inelastic and an increase in the money supply does not necessarily cause an increase in investment. Demand for money for working capital purposes is more elastic, since in the short run, profits are not so dependent on a low level of interest rates.

Full employment. Another criterion for Federal Reserve credit policy is that of maintaining full employment. The basis for this type of guide is expressed in the Employment Act of 1946 which stated:

The Congress hereby declares that it is the continuing policy

¹Klise, op. cit., pp. 651-3. ²Thomas, op. cit., p. 508.

and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, agriculture, labor, and State and local governments, to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and the general welfare, conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power.¹

The Federal Reserve System accepted full employment as a guide to credit policy while maintaining "reasonable stability for the value of the dollar."²

The policy of maintaining economic stability at full employment received emphasis from the theories of John Maynard Keynes. According to Keynes, equilibrium, or economic stability, is possible at less than full employment.³ With this possibility existing, achieving economic stability does not insure full employment. Therefore, full employment should be the goal rather than stability alone.

Keynes also felt that savings must equal investment to insure full employment, and in a mature economy more savings occur, but investment outlets are more difficult to find. The only way for investment to

¹The Employment Act of 1946, Section 2, cited by George Walter Woodworth, The Monetary and Banking System (New York: McGraw-Hill Book Company, Inc., 1950), p. 574.

²U. S. Congress, Joint Committee on the Economic Report, Monetary Policy and the Management of the Public Debt, Replies to Questions, 82d Congress, 2d Sess., Sen. Doc. No. 123, Part 1, February 1952, (Washington: Government Printing Office, 1952), p. 238.

³Dudley Dillard, The Economics of John Maynard Keynes: The Theory of a Monetary Economy (Englewood Cliffs, New Jersey: Prentice-Hall, Inc., 1948), p. 59.

keep pace with savings is for the interest rate to fall drastically. This drop in interest was not likely to happen under private enterprise alone.¹

The full employment criteria requires an easy money policy by the Federal Reserve Banks when employment falls below a desired level. If the threat of inflation becomes evident a general tightening of credit is necessary. In cases of severe unemployment it would be necessary for the Federal Government to embark on a fiscal policy which would assist in achieving the goal of full employment.

One of the greatest problems to be faced in seeking full employment is inflation. As employment increases, bottlenecks appear in the supply of goods whose production cannot readily be increased. This tends to upset stability by driving prices up. Wages are also forced up as the demand for labor increases. Therefore, as the goal of full employment is reached, the goal of price stability is threatened.²

II. TECHNIQUES OF CONTROL

Having determined a credit policy, the Federal Reserve System carries it out through its credit control powers. These powers are of two types, quantitative and qualitative. Quantitative controls are used to regulate the quantity of money available to the economy and are

¹John Arthur Estey, Business Cycles: Their Nature, Cause, and Control. (third edition; Englewood Cliffs, New Jersey: Prentice-Hall Inc., 1956), pp. 267-9.

²Thomas, op. cit., pp. 756-7.

used to affect the reserves of member banks. They consist of reserve requirements, the discount rate, and open market operations. Qualitative controls are those which seek to limit the amount of money available for certain purposes.

The nature of reserves. Every member bank of the Federal Reserve System is required to keep funds on deposit in a Federal Reserve Bank. This account serves to aid in the clearing of checks and acts as a reserve against deposits. Historically, banks were required to keep a sum of money available as a reserve to redeem their notes and customer's deposits. Since the establishment of the Federal Reserve System, this money has been held by the Reserve Banks rather than the commercial banks.

The deposits in the Federal Reserve Banks form a major portion of the legal reserves of the member banks. They consist of two parts; required reserves, which are a fractional amount of the commercial bank's total deposits, and excess reserves, which are legal reserves in excess of required reserves.¹ As of December 1, 1959 banks have been permitted to count as part of their required reserves vault cash in excess of a percentage of net demand deposits.²

Since the commercial banks operate on a fractional reserve basis,

¹Klise, op. cit., p. 250.

²Forty-Sixth Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1959 (Washington: Board of Governors of the Federal Reserve System, 1960), p. 82.

the banks as a whole are able to expand their loans by an amount which is greater than new money which is deposited. To illustrate, assume commercial banks are required to keep 20% of their deposits as legal reserves in the Reserve Banks and with no excess reserves initially. With a new deposit of \$100, a bank must deposit \$20 with the Reserve Bank and is free to loan out \$80. The \$80 could be loaned to a customer who would pay his creditors. The creditors in turn might deposit the \$80 in a second bank which would deposit \$16 in the Reserve Bank and be able to loan out \$64. The \$64 could be loaned out and later deposited in a third bank which could loan \$51.20. Thus, the banking system as a whole is able to increase its customers' deposits \$500, which is an amount equal to the new money received times the reciprocal of the required reserve. Similarly, if an amount of money is withdrawn and not returned to the banks, the banking system would be forced to contract deposits by the amount of the withdrawal times the reciprocal of the required reserve.

This illustration does not take into account the practical limitations of the expansion process. It assumes all money loaned is returned to the banks. If the public decides to hold more hand-to-hand money, this expansion will not occur. A second limitation on the multiplying effect is the time required for the transactions to occur. A third limitation is the willingness of the banks to make loans.

Although the banking system as a whole can lend several times its excess reserves, an individual bank can safely loan only the amount of its excess reserves. The reason for this is the possibility that deposits

created through loans may be transferred to another bank in the system. If this should happen, the original bank will have its required reserves lowered beyond the legal minimum, or its vault cash reduced.

The Federal Reserve System controls bank credit in part by its action on member bank reserves. To expand credit, it increases reserves; to contract credit, it decreases reserves. The commercial banks can mitigate somewhat the effect of Federal Reserve action by their own operating policies. To expand credit while the Federal Reserve is decreasing reserves, the banks can sell their investments, such as Government bonds, which will increase their excess reserves and enable them to make additional loans. If the Federal Reserve is attempting to expand credit, the commercial banks are under no obligation to make additional loans.

The specific ways in which the Federal Reserve System affects reserves are shown in the next three sections.

Reserve requirements. Member banks of the Federal Reserve System are required to keep on hand or in their accounts at the Reserve Banks, an amount of money equal to a percentage of their deposit liabilities. This percentage is their reserve requirement. The Federal Reserve System has the authority to change the percentages within limits as a control measure. If they wish to expand credit, they can reduce the requirements, thereby converting required reserves to excess reserves and increasing bank loaning capacity. To tighten credit, reserve requirements may be increased. This will reduce excess reserves and bank loaning capacity.

Banks, for the purposes of reserve requirements, are presently classified as central reserve city banks, reserve city banks, and country banks. Central reserve city banks are the downtown banks in New York and Chicago and carry the highest reserve requirements. Reserve city banks are the downtown banks in chief financial centers, other than New York and Chicago. All other member banks are classified as country banks and carry the lowest reserve requirements.¹

Deposits in banks are classified as demand deposits or time deposits. Demand deposits, which are subject to withdrawal either on demand or with less than 30 days notice, carry a higher reserve requirement than time deposits, which are theoretically subject to a waiting period before withdrawal. The reserve requirements in force as of December 31, 1959 are shown in Table I.

TABLE I

RESERVE REQUIREMENTS IN EFFECT,
DECEMBER 31, 1959*

Classification of bank	Demand deposits	Time deposits
Central reserve city	18%	5%
Reserve city	16½%	5%
Country	11%	5%

*Forty-Sixth Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1959, op. cit., p. 122.

¹Albert Gailord Hart, Money, Debt, and Economic Activity (second edition; New York: Prentice-Hall, Inc., 1953), pp. 23-4.

The original act which established the Federal Reserve System set reserve requirements at 18% for central reserve city banks, 15% for reserve city banks and 12% for country banks. Requirements on time deposits were set at 5% for all banks. The amendment of the act in 1917 reduced the requirements to 13%, 10%, and 7% on demand deposits and to 3% on time deposits in order to compensate the banks from no longer counting vault cash as part of their reserves.¹ In 1935 the Federal Reserve was given discretionary powers to vary the requirements, with limits set at 13-26% for central reserve city banks, 10-20% for reserve city banks, and 7-14% for country banks. Time deposit requirements could be varied from 3% to 6%. The reserve banks were given temporary authority in 1948-49 to raise rates slightly over those set in 1935.² In 1959, limits for central reserve city banks and reserve city banks were set at 10-22%.³

Discount rate. Member banks are permitted to obtain additional reserves from the Federal Reserve Banks through borrowing. This is accomplished in two ways. They can rediscount their customer's notes or receive advances from the Reserve Banks. The rate of interest the Reserve Banks charge is the discount rate.

¹In 1959, the banks were again allowed to count some of their vault cash as reserves. Cf. p. 13.

²Klise, op. cit., pp. 251-2.

³Forty-Sixth Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1959, op. cit., p. 122.

Initially, in order to borrow from the Reserve Banks, member banks had to present eligible paper for rediscount. Eligible paper consisted of drafts, notes or bills arising out of loans for working capital for industrial, commercial or agricultural purposes. Agricultural paper could have a maturity of six months, later extended to nine months, while other paper could not have a maturity greater than 90 days. When the use of advances was authorized, eligible paper or Government obligations could be used as collateral for them. In 1932, Federal Reserve Banks were authorized to make advances on collateral which was technically ineligible, but satisfactory to the Reserve Banks. These loans called for an interest rate $\frac{1}{2}$ of 1% above the discount rate.¹

Member banks are generally reluctant to borrow from the Federal Reserve Banks, and once in debt are anxious to repay. One reason for this is the chance of criticism from depositors or the Federal Reserve Bank itself when a bank is constantly in debt to a Reserve Bank. A second consideration is that borrowed funds may be more expensive than those obtained through deposits. As a result, banks normally borrow only to restore their reserve positions to the legal minimum.²

The use of the discount rate by the Federal Reserve System consists of two parts. First, the Federal Reserve policy of encouraging loans and lowering the discount rate in depression, and discouraging

¹Klise, op. cit., pp. 203-12.

²The Federal Reserve System: Purposes and Functions (third edition; Washington: Board of Governors of the Federal Reserve System, 1954), pp. 32-8.

loans and raising the discount rate in expansion serves as a control on credit expansion. The second and more important function of the discount rate is to serve as an objective index of Federal Reserve policy. Changes in the discount rate indicate to the public whether the Federal Reserve System is seeking to expand or contract credit.¹

Open market operations. The Federal Reserve System takes a more positive step toward credit control through its open market operations, that is, the buying and selling of Government securities in the open market.

If the Federal Reserve Banks wish to expand credit, they can buy securities in the open market. The check in payment for the securities will be deposited in the seller's bank and returned to the Federal Reserve Bank which issued the check. This action will increase the reserves of the commercial bank and enable it to increase its loans. By the process of credit expansion, these additional funds will be diffused throughout the banking system. Similarly, if the Federal Reserve System wishes to restrict credit, they can do so by selling securities in the open market.

The power that the Federal Reserve System had to influence credit through open market operations was not realized initially. Federal Reserve Banks were permitted to engage in open market operations; however, it was felt that this authority was to be used to give Reserve

¹Ibid.

Banks an opportunity to obtain earning assets when commercial banks were not discounting paper. In the early 1920's, the Federal Reserve discovered that open market purchases resulted in an approximately equal drop in member bank borrowing. The purchases served to increase their reserves, thus removing the necessity to borrow to bring reserves up to the minimum level. From then on, open market operations were used principally as a method of credit control.¹

The degree of control achieved by open market operations depends on the initial reserve position of the commercial banks. Open market sales begun at a time when banks have large amounts of excess reserves will not be as effective as at a time when the banks have little or no excess reserves. The principle objective of open market sales is to force banks into debt to the Reserve Banks.² When the banks are in debt, increases in the discount rate will encourage them to liquidate their indebtedness as quickly as possible.

Open market operations are not the only factors that affect bank reserve positions. Some of the other factors are float, Treasury balances, foreign accounts, and currency in circulation. Float arises from the check clearing process. Banks are given credit for checks presented to the Federal Reserve after a maximum deferment of two days. Anything that delays the collection process will add to reserves as a whole, since the check will be credited to the receiving bank and not yet charged

¹Klise, op. cit., pp. 225-31.

²The Federal Reserve System: Purposes and Functions, op. cit., p. 42.

against the bank on which the check was drawn.

Many commercial banks are depositories for Federal Tax funds. As the balances are withdrawn from these banks, there is an immediate effect on reserves, since payment is effected by crediting the Treasury account at the Federal Reserve Bank and charging the account of the commercial bank. The Treasury has attempted to reduce the effect on reserves by giving banks advance notice before withdrawals are made.

Official accounts of foreign monetary authorities are held by the Federal Reserve Banks. Additions to and withdrawals from these accounts have the same immediate effect on member bank reserves as changes in the Treasury account at the Federal Reserve Banks.

The movement of currency from the banks to the public causes a roughly corresponding decrease in bank reserves. Banks needing currency request it from the Federal Reserve Banks which charge the commercial banks' accounts on delivery. Return of currency from commercial banks to Reserve Banks has an opposite effect. There is a normal seasonal flow from commercial banks to the public during the Christmas season and around holidays. These funds are normally returned to the banks after each holiday.¹

In the practical operation of open market transactions, the effect of these other factors on reserve positions must be taken into account. Bank reserve positions will tend to tighten or ease because of these

¹Robert V. Roosa, Federal Reserve Operations in the Money and Government Securities Markets (New York: Federal Reserve Bank of New York, 1956), pp. 66-76.

other factors. From that starting point, open market operations are conducted to achieve the final desired degree of tightness or ease.

Selective credit regulation. Qualitative credit controls are those which seek to regulate the purposes for which credit is granted. Among these are stock market margin requirements, consumer credit regulations, real estate credit controls, and voluntary credit restraint programs.

The Federal Reserve Board is permitted to regulate stock market credit through the use of margin requirements. Margin is the difference between the price of a security and the amount which may be borrowed for the purpose of buying and holding of the security. The excessive speculation in the security markets during 1928 and 1929 led to the passage of the Securities Exchange Act of 1934, which gave the Federal Reserve Board authority to set margin requirements. Margin requirements do not actually prevent speculation; however, they limit the funds that can be borrowed for speculation.¹

The Board's authority extends to all banks, brokers, and dealers who loan money on registered securities. It does not extend to loans involving obligations of the Federal and State governments. Margin requirements do not apply to unregistered securities traded in the over-the-counter market. Loans for purposes other than purchasing and holding securities are exempt even though securities may be used as collateral.²

Consumer credit regulation by the Federal Reserve Board has been

¹Kent, op. cit., pp. 523-4.

²Ibid.

permitted at times since 1941. The purpose of the regulations was to restrict the use of credit on the purchase of consumer durable goods. The regulations provided for a limit on the amount of credit granted on any article included, and a limit on the time allowed for repayment.¹ In addition to the control of the amount of credit, the regulations acted as a brake on price levels. Lack of available credit tends to reduce consumer demand, while uniform credit restrictions promote price competition rather than competition in credit terms.

Regulation of real estate credit similar to that of consumer credit was permitted for a short period of time. Authority was contained in the Defense Production Act of 1950. The controls for the regulation of real estate credit were suspended in September, 1952.²

A program for voluntary credit restraint by lenders was initiated in March, 1951. Under the auspices of the Federal Reserve System, a National Voluntary Restraint Committee was formed which consisted of representatives of commercial banks, life insurance companies, investment bankers, mutual savings banks, and saving and loan institutions. The committee issued a Statement of Principles which set forth broad standards for determining whether a loan would involve essential or non-essential use of funds in the face of national defense requirements. Further bulletins were issued by the committee until the program was

¹The Federal Reserve System: Purposes and Functions, op. cit., pp. 60-3.

²Kent, op. cit., pp. 526-7.

¹The Federal Reserve System: Purposes and Functions, op. cit., pp. 60-7.

suspended in May, 1952.¹

The Federal Reserve System, 1952-1959

The Federal Reserve System's policy of monetary growth and expansion was a key factor in the system's credit policy. In 1952, the system's policy was to maintain a steady rate of growth in the money supply. This policy was based on the belief that a steady rate of growth in the money supply would lead to a steady rate of growth in the economy. The system's policy was to maintain a steady rate of growth in the money supply at a rate of 4% to 5% per year. This policy was based on the belief that a steady rate of growth in the money supply would lead to a steady rate of growth in the economy. The system's policy was to maintain a steady rate of growth in the money supply at a rate of 4% to 5% per year. This policy was based on the belief that a steady rate of growth in the money supply would lead to a steady rate of growth in the economy.

II. THE FEDERAL RESERVE SYSTEM

The Federal Reserve System was created in 1913 to provide a central bank for the United States. The system's primary purpose was to maintain a steady rate of growth in the money supply. The system's policy was to maintain a steady rate of growth in the money supply at a rate of 4% to 5% per year. This policy was based on the belief that a steady rate of growth in the money supply would lead to a steady rate of growth in the economy. The system's policy was to maintain a steady rate of growth in the money supply at a rate of 4% to 5% per year. This policy was based on the belief that a steady rate of growth in the money supply would lead to a steady rate of growth in the economy.

¹The Federal Reserve System, 1952-1959, pp. 65-7.

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CHAPTER III

FEDERAL RESERVE CREDIT POLICY ACTION, 1951-1959

In pursuing its objective of promoting stable growth and stability, the Federal Reserve System changes its credit policy to fit economic conditions. This chapter explains how credit policy was determined and how the tools of credit policy were used from 1951 to 1959. The dates of the periods of different credit policies were based on changes in the open market policy directives of the Federal Open Market Committee.

I. THE ACCORD

In early 1951, the major monetary problem in the economy was the threat of inflation. The outbreak of the Korean War in June, 1950 and the Chinese Communist intervention caused considerable upward pressure on commodity prices. The wholesale price index rose from 156 in May, 1950 to 184 in March, 1951. During the same period the consumers' price index rose from 169 to 185. Standard and Poor's Corporation Common Stock Index stood at 175 in February, 1951 compared with 147 in May of 1950.¹ The inflation in prices was aided by the widespread use of credit. Bank loans rose ten billion dollars, which was over 20%, from June, 1950 to March, 1951.² The Federal Reserve System was severely handicapped in

¹"Financial, Industrial, and Commercial Statistics: United States," Federal Reserve Bulletin, XXXVII (June, 1951), 679-701.

²Ibid., p. 667.

restricting credit expansion due to its policy of supporting the market in Government securities.

The Government securities market support program was begun in 1942 as a method of aiding the financing of World War II. The Federal Reserve System cooperated with the Treasury by setting up a pattern of interest rates on Government securities ranging from $2\frac{1}{2}\%$ on long-term bonds to $3/8\%$ on 91-day bills.¹ The Federal Reserve System stood ready to buy in the open market when the prices of securities fell below those equivalent to the established rates. Commercial banks preferred to hold the long-term issues since they carried a higher interest rate and were readily convertible into legal reserves because of their high marketability. As a result, the Reserve Banks were forced to buy more and more short-term issues in their support program. In 1947, upon consultation with the Treasury, the Federal Reserve System ended its support of Treasury bills, but continued its support of the bond market. This action resulted in reducing the spread between long and short-term rates.² After dropping its support of the bills, the Federal Reserve System was able to reduce its holdings of short-term securities, replacing them with long-term bonds.³

¹Edwin W. Kemmerer and Donald L. Kemmerer, The ABC of the Federal Reserve System (twelfth edition; New York: Harper & Brothers Publishers, 1950), pp. 172-4.

²Ibid., pp. 187-94.

³Thirty-Eighth Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1951 (Washington: Board of Governors of the Federal Reserve System, 1952), p. 66.

Statistical Statement of the Board of Governors, Aug. 1951, p. 11.

While supporting Government securities, open market operations were ineffective as a means of controlling credit expansion. Member banks held large amounts of Government securities; fifty-two billions were held as of December 30, 1950, representing over 50% of their earning assets.¹ If the Federal Reserve should attempt to restrict credit through open market sales, the banks could increase their reserves by selling bonds in the open market. The Federal Reserve System would be forced to buy them as soon as the price dropped below the support price. The Federal Reserve was under extreme pressure from the Treasury to refrain from open market sales and to continue support of bonds in order to keep interest rates low. Another consideration that prevented the ending of bond support was the effect of strong open market sales on the value of bonds held by banks and non-bank investors.

The Federal Reserve System, concerned with the inflationary pressures, wanted to withdraw its support of the bond market and engage in open market sales. The Treasury wanted to be in a position to raise all the money necessary for the Korean War as cheaply as possible and for the commercial banks to make ample credit available for war industry. For the accomplishment of these objectives, the Treasury felt that Federal Reserve support of the bond market was necessary. The divergence of objectives resulted in a controversy between the Federal Reserve and the Treasury.

In August, 1950 the controversy came to a head in a Treasury

¹Financial, Industrial, and Commercial Statistics: United States," Federal Reserve Bulletin, June, 1951, op. cit., p. 667.

refunding operation. The Treasury offered to exchange new notes for maturing notes at the same rate of interest. The Federal Reserve bought the new notes to insure success of the refunding, but sold nearly enough long-term securities to offset the purchases.¹ In December, 1950 the Federal Reserve refused to support refunding of long-term bonds on the day of issue.²

The Secretary of the Treasury, John Snyder, enlisted the aid of President Truman in an effort to force the Federal Reserve to continue the support of Government securities. Accordingly, President Truman called the Open Market Committee to a meeting at the White House. At the meeting the President tried to influence the Committee to support the Treasury's position, but received no promises for continued support of the market. The President later appointed a committee to seek a compromise between the Federal Reserve and the Treasury. However, agreement was reached between the two agencies without the aid of the committee on March 4, 1951.³

The following statement concerning the Accord was issued by the Open Market Committee on March 4, 1951:

The Treasury and the Federal Reserve System have reached full accord with respect to debt management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time,

¹"The Managers of the Dollar," Fortune, XLV (February, 1952), 218.

²George Soule, "The Price of Money: The Federal Reserve Versus the Treasury," The Yale Review, XLI (June, 1952), 604-5.

³"The Managers of the Dollar," Fortune, op. cit., pp. 215-7.

to minimize monetization of the public debt.¹

In reaching the Accord, officials of both the Federal Reserve and the Treasury agreed on three areas of debt management. They were the long-term bonds which were overhanging the market, the refunding of short-term debt, and the raising of new long-term funds.

It was agreed that the Treasury would offer a new non-marketable 2 3/4%, twenty-nine-year bond in exchange for long-term bonds then outstanding. The new bonds would be redeemable before maturity by conversion into marketable five-year Treasury notes. The purpose of this action was to induce long-term investors to retain their Government securities, rather than place them on the open market. In order to maintain an "orderly market," the Federal Reserve pledged to continue to support the market, but only on a scale-down of prices.²

In the case of short-term securities, the Federal Reserve would immediately reduce or discontinue purchases and permit the market to seek its own level. This would place commercial banks in a position where they would have to depend on borrowing from the Federal Reserve Banks for short-term funds to avoid selling at a loss in the market. It was contemplated that the interest rate would fluctuate around the discount rate. The Federal Reserve authorities expected that the discount rate would remain at the 1 3/4% rate which was then in effect. The

¹Thirty-Eighth Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1951, op. cit., p. 98.

²Ibid., pp. 100-1.

Federal Reserve also agreed to operate in the market to insure success of the refunding operations.¹

The program for exchange of bonds did meet with some success. Holders of the long-term $2\frac{1}{2}\%$ bonds exchanged $13\frac{1}{2}$ billion dollars of the nearly twenty billion dollars of bonds outstanding for the non-marketable $2\frac{3}{4}\%$ bonds. Included in that total was $5\frac{1}{2}$ billions held by the Federal Reserve System and Government investment accounts. On March 12, 1951, the Federal Reserve unpegged the bond market and allowed long-term bonds to fall below par. The Federal Reserve Banks continued to buy and prices remained at ninety-nine or higher. In April, after the conversion offer expired, the Federal Reserve reduced its support buying and the market price dropped below ninety-seven.² The Board of Governors reported that after June the Federal Reserve System bought practically no long-term bonds in support of the market.³

The Accord resulted in several far-reaching developments in Federal Reserve policy. The first of these was the assertion of its independence of the Treasury by the Federal Reserve System. Since 1942, Federal Reserve credit policy had been dominated by the Treasury's desire to finance the public debt at a low rate of interest. With its newly-won

¹Ibid.

²Roy L. Reierson, "Recent Developments in Federal Reserve Policy," The Commercial and Financial Chronicle, CLXXIV (August 16, 1951), 620.

³Thirty-Eighth Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1951, op. cit., pp. 4-5.

independence, the Federal Reserve was in a position to pursue a credit policy of its own. As E. A. Goldenweiser, former Director of the Division of Research and Statistics for the Board of Governors, wrote:

By its terms the Treasury agreed in effect to stand on its own feet, without artificial props, in its dealings with the money market, and the Federal Reserve agreed to keep in close touch with the market, to prevent untoward developments—but not to create artificially easy credit conditions for the benefit of Treasury issues or to underwrite any particular level of prices or yields for these issues.¹

The independence of the Federal Reserve was not complete, however, since it did agree to furnish some support to the bond market, particularly in refunding operations. The maintenance of "orderly conditions" in the bond market was to prevent a severe decline in bond prices, which might lead to a lack of confidence in Government securities.

A second result of the Accord was the abandonment of low interest rates as a criterion of Federal Reserve credit policy. Prevention of price inflation became the immediate objective of the Federal Reserve. It was recognized that maintenance of low interest rates could not achieve stability, but that a variable credit policy is a necessary program toward that goal.

Another result of the Accord was the reinstatement of open market operations as an instrument of credit control. During the period of bond support, the Federal Reserve System was not able to absorb excess reserves through selling operations. The support program established a

¹Emanuel A. Goldenweiser, "A Free Federal Reserve System," Dun's Review, IX (September, 1952), 93.

floor under the market and the Federal Reserve could only sell down to that floor. This prevented any large-scale selling as a control measure. With the end of the support policy, the banks could be forced into debt to the Federal Reserve Banks, which gave added importance to the discount rate as a control measure. In addition, since the Accord was reached during a period of inflation, the end of firm bond support was a control measure in itself, since banks would be reluctant to increase legal reserves by selling bonds at a loss in the market.

Reaching of the Accord had an effect on interest rates in general, and on Treasury rates in particular. The Treasury could expect to pay higher interest rates on Government bonds, especially during periods of expansion. Market rates of interest would tend to be set by the forces of supply and demand, rather than through the effect of a floor on the Government bond market.

II. CREDIT RESTRAINT, MARCH 1951 TO MAY 1953

The policy of credit restraint that was begun at the outbreak of the Korean War was continued in effect until May of 1953. The authority to conduct open market operations carried throughout 1951 the instruction that transactions should be conducted "with a view to exercising restraint upon inflationary developments, to maintaining orderly conditions in the Government securities market."¹ Later authorizations carried

¹Thirty-Eighth Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1951, op. cit., pp. 96 ff.

similar statements.

The main reliance for credit control was through the selective controls rather than the quantitative. Reserve requirements in effect in March, 1951 were not changed during the period. The discount rate, as was agreed upon in the Accord, was not changed until January, 1953, when it was raised to 2% from the 1 3/4% in effect during 1951, even though banks borrowed heavily from the Federal Reserve in the last half of 1952 and 1953. Controls on consumer and real estate credit were instituted and later dropped, as well as a voluntary credit restraint program. Margin requirements remained at the 75% level until February, 1953 when they were dropped to 50%.

A unique feature of this period of restraint was the use of a voluntary credit restraint program by the Federal Reserve System. The program was initiated under the Defense Production Act of 1950 which authorized the President to encourage financing institutions to enter into voluntary agreements and programs to restrain unnecessary credit expansion. The President delegated the authority to the Board of Governors, who established a Voluntary Credit Restraint Committee. The Committee was composed of four representatives each from banks, insurance companies, and investment banking houses,¹ and had the responsibility of establishing the criteria for distinguishing between essential and non-essential credit. As the Federal Reserve Bulletin stated:

¹Later two representatives each from mutual savings banks and savings and loan associations were added.

The program had the purpose of guiding lending agencies to extend credit in such a way as to help maintain and increase the strength of the domestic economy through the restraint of inflationary tendencies and at the same time to help finance the defense program and the essential needs of agriculture, industry and commerce.¹

The Committee functioned by means of bulletins which were distributed to all financial institutions participating in the program. The program was suspended on May 5, 1952, and the authority for the program expired on June 30, 1952.

Consumer credit regulations were in effect during this period under the Federal Reserve Board's Regulation W, which was reinstated in September, 1950. Controls were placed on the minimum down payments and maximum maturities of installment contracts for consumer durable goods and home improvements. For new and used automobiles, the minimum down payment was one-third and the maximum maturity was twenty-one months. The terms required for television sets and household appliances were 15% down payment with eighteen months to complete payment; required down payment for furniture was only 10%.²

Installment credit terms were stiffened on October 16, 1950 to provide for higher down payments on appliances and furniture, and shorter maturities for all durable goods installment contracts under the regulations. Controls on consumer goods finally were dropped on May 7,

¹"Program for Voluntary Credit Restraint," Federal Reserve Bulletin, XXXVII (March, 1951), 263.

²"Installment Credit Terms Before and After Regulation," Federal Reserve Bulletin, XXXVII (July, 1951), 800-1.

1952.¹

The consumer credit regulations had a beneficial effect on halting the expansion of consumer credit. Consumer credit remained approximately equal to or less than the thirteen billion dollars outstanding at the beginning of controls throughout the control period.² After Regulation W was dropped, consumer credit rose rapidly, reaching eighteen billion dollars in December, 1952.³

Regulation X, concerning real estate credit was put into effect in October, 1950. It specified minimum down payments and maximum maturities on a sliding scale in the granting of real estate loans. The amendments to the Defense Production Act of 1950, which were passed on June 30, 1952, provided for relaxation of real estate credit if, in any three consecutive months, housing unit starts fell below an annual rate of 1,200,000. Housing starts fell below this figure in the summer of 1952, but before the relaxation was effected, the entire regulation was dropped.

Much of the open market purchasing in the first part of the period was for maturing short-term issues which were not being exchanged for new issues. In June, 1951 the Federal Reserve System bought one billion dollars in short-term securities to assist the Treasury in a refunding

¹"Consumer Credit," Federal Reserve Bulletin, XXXVIII (May, 1952), 497.

²"Recent Credit Expansion," Federal Reserve Bulletin, XXXVIII (December, 1952), 1271.

³"Financial, Industrial, and Commercial Statistics: United States," Federal Reserve Bulletin, XXXIX (November, 1953), 1214.

operation. In September and October of 1951 the Federal Reserve again came to the aid of the Treasury by buying \$500 million of short-term securities. In December the Federal Reserve supplied seasonal reserves by purchasing large amounts of securities in the open market.¹ After Christmas in 1951 these funds were absorbed by offsetting sales. Large purchases of short-term issues were made during refunding operations in February, June, August, and September of 1952. Much of these purchases were offset through concurrent sales of long-term bonds.² In December of 1952, the Federal Reserve Banks held \$24.7 billion of Government securities, which was an increase of \$900 million over December, 1951.

The Federal Reserve increased the use of repurchase agreements during 1952.³ Under these agreements, dealers sold bonds to the Federal Reserve and bought them back within a short period, usually 15 days. The purpose of this arrangement was to relieve temporary tightness in the money market without making a permanent addition to the reserve base. They were essentially advances granted to non-members of the Federal Reserve System on bond collateral.

The Federal Reserve System began in December, 1952 a policy of

¹Thirty-Eighth Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1951, op. cit., pp. 5-7.

²Thirty-Ninth Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1952 (Washington: Board of Governors of the Federal Reserve System, 1953), p. 3.

³Ibid.

refraining from support of Treasury refunding operations.¹ In March, the Federal Open Market Committee adopted the following policy on operating procedure:

(1) Under present conditions, operations for the System account should be confined to the short end of the market (not including correction of disorderly markets);

(2) It is not now the policy of the Committee to support any pattern of prices and yields in the Government securities market, and intervention in the Government securities market is solely to effectuate the objectives of monetary and credit policy (including correction of disorderly markets);

(3) Pending further study and further action by the Committee, it should refrain during a period of Treasury financing from purchasing (1) any maturing issues for which an exchange is being offered, (2) when-issued securities, and (3) outstanding issues of comparable maturity to those being offered.²

The policy was narrowly passed over the objections of the President of the Federal Reserve Bank of New York who did not wish to be limited to the short-term market. At the following meeting, the policy was voted down; at the next meeting it was reinstated.³ This policy indicated that the Federal Reserve would no longer support Treasury securities except to prevent large drops in security prices.

III. CREDIT EASE, MAY 1953 TO JANUARY 1955

Toward the spring of 1953, trouble spots began to appear in the economy. Demand for credit was strong and tended to outstrip the available supply. In April of 1953, the Treasury's new $3\frac{1}{4}\%$ bonds fell below

¹Fortieth Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1953 (Washington: Board of Governors of the Federal Reserve System, 1954), p. 8.

²Ibid., p. 88. ³Ibid., pp. 88 ff.

par, and the bond market in general suffered a severe decline. Inventories in the hands of manufacturers, wholesalers, and retailers accumulated in the second quarter of 1953 at a rate twice that of the first quarter.¹ Heavy consumer installment purchases increased the credit demand, but failed to reduce the inventory buildup. Commercial banks, which were heavy borrowers from the Federal Reserve during the first half of 1953, reduced their holdings of Government securities in order to maintain their reserve positions. Prices apparently remained stable, but this was the net result of counteracting movements in individual commodities.²

In recognition of these factors, the Federal Reserve System took steps to relieve the pressure on bank reserves. Open market purchases were begun in May and continued until December. The authority for the executive committee of the Federal Open Market Committee to conduct open market operations was changed in the meeting of June 11, 1953 to read: "with a view to avoiding deflationary tendencies without encouraging a renewal of inflationary developments (which in the near future will require aggressive supplying of reserves to the market)."³

On June 24, 1953, the Board of Governors of the Federal Reserve System announced a reduction in reserve requirements for all member

¹Allen Sproul, "A Defense of Federal Reserve Policy," Commercial and Financial Chronicle, CLXXXI (April 14, 1955), 1727, 1752-3.

²Ibid., p. 1727.

³Fortieth Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1953, op. cit., p. 92.

banks. Country bank requirements were cut from 14% to 13%. Requirements for reserve city banks were dropped from 20% to 19% and central reserve city banks from 24% to 22%. In making the announcement, the Board stated:

This step was taken in pursuance of Federal Reserve policy, designed to make available the reserve funds necessary to meet the essential needs of the economy and to help maintain stability of the dollar. The reduction, releasing an estimated \$1,156,000,000 of reserves, was made in anticipation of the exceptionally heavy demands on bank reserves which will develop in the near future when seasonal requirements of the economy will expand and treasury financing in large volume is inescapable. The action is intended to provide assurance that these needs will be met without undue strain on the economy and is in conformity with System policy of contributing to the objective of sustaining economic equilibrium at high levels of production and employment.¹

In connection with the reduction in reserve requirements of June, 1953, banks were supplied with an additional one billion dollars in reserves through the purchase of Treasury bills by the Federal Reserve Banks.²

After mid-year 1953, the economy suffered a mild recession which lasted until the spring of 1954. The index of industrial production dropped from a peak of 137 in mid-1953 to 123 in March, 1954. Thereafter it rose, reaching a high of 130 in December, 1954. The truce in Korea in 1953 resulted in a large drop in Government defense outlays which reinforced the recessionary trend. From a pre-truce rate of \$54 billion per year, Government spending for national security dropped to \$40½ billion annually. Many factors of the economy remained at a high level through-

¹Recent Credit and Monetary Developments," Federal Reserve Bulletin, XXXIX (July, 1953), 689.

²Ibid.

out the recession, and increased in the last half of 1954. Consumer spending showed only a slight drop at the end of 1953 and then continued to reach record heights during 1954. Residential construction remained strong due to the plentiful supply of excess reserves available for mortgage lending. Inventories began to drop in the fourth quarter of 1953 and reduction continued during 1954.¹

Interest rates dropped as the bank reserve positions improved. The rate on Treasury bills, which fluctuated around the discount rate of 2% during the first half of 1953, dropped to around 1% during 1954. In February, 1954, the discount rate was dropped to 1 3/4%, and lowered again to 1 1/2% during April and May. This action had little effect on member bank borrowing since they were already well supplied with reserves. It did, however, serve to put the discount rate into a more customary relationship with market interest rates.²

Open market purchases were made in the last half of 1953 to free additional reserves for the usual seasonal requirements. Over two billion dollars in Government securities were added to Federal Reserve System holdings from April to December. Seasonal needs were not as heavy as anticipated, and the banks used the additional reserves to reduce borrowings from the central banks. By 1954, banks were generally out of debt

¹Forty-First Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1954 (Washington: Board of Governors of the Federal Reserve System, 1955), p. 2-3.

²M. S. Szymczak, "Federal Reserve Policy Since 1953," Commercial and Financial Chronicle, CLXXX (October 7, 1954), 1387, 1410-1

to the Federal Reserve, while excess reserves were increasing.

In June and July, 1954, the Federal Reserve further reduced reserve requirements. Requirements were cut to 20% for central reserve city banks, 18% for reserve city banks, and to 12% for country banks. Requirements for time deposits were dropped from 6% to 5% for all classes of banks. This step was taken to make funds available to assist the Treasury's borrowing operations and to meet seasonal needs. This action released 1½ billion dollars of reserves and it was anticipated that this would more than meet the credit needs of the economy. As the Board of Governors stated:

Changes in reserve requirements supply or withdraw relatively large amounts of bank reserves, even when effected on a gradual basis, as in the present action.¹ Accordingly, such changes are comparatively infrequent. For more flexible and frequent adjustments to the credit needs of the economy the System relies chiefly upon open market operations to release or absorb reserve funds.²

The Federal Reserve absorbed some of the funds released through the drop in reserve requirements by open market sales. In July and August, 1954, the Federal Reserve System reduced its Government securities holdings by one billion dollars.

At the June, 1954 meeting of the Open Market Committee, it was noted that the decline had slackened in production, employment, and consumption, and industrial output and construction activity had advanced

¹Reserve requirements for central reserve city banks were actually reduced in two steps, thirty-five days apart.

²Forty-First Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1954, op. cit., p. 89.

to record levels. Other elements in the economy, however, were still depressed. The Committee at that time decided to continue its credit policy of active ease. At the next meeting in September, the Committee again renewed its policy of active ease.¹

At the next meeting, held December 7, 1954, the Federal Open Market Committee shifted its credit policy from active ease to one of simply ease. During the meeting, the Committee noted that most economic indicators were expanding and an air of optimism was prevalent. The Committee at that time felt the situation did not yet call for a policy of restraint, but one month later the credit policy was changed to one of restraint.²

IV. CREDIT RESTRAINT, JANUARY 1955 TO NOVEMBER 1957

As the economy recovered from the recession, the credit policy began to shift from ease to restraint. At its meeting of January 11, 1955, the Open Market Committee changed the wording of the directive to provide for transactions with a view "to fostering growth and stability in the economy by maintaining conditions in the money market that would encourage recovery and avoid the development of unsuitable expansion." This wording replaced the clause that called for maintaining a condition of ease. As one step in restraining the volume of credit in the stock

¹Forty-First Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1954, op. cit., pp. 94-7.

²Ibid., pp. 97-8.

market, the Board of Governors raised margin requirements to 60% effective January 4, 1955.¹

By the spring of 1955, the economy had fully recovered from the recession of 1953-4. Gross national product reached an annual rate of \$375 billion, \$5 billion above the 1953 peak. Accordingly, the instruction to the executive committee of the Federal Open Market Committee dropped the term "encourage recovery." In an effort to restrain credit somewhat, the Board of Governors approved the raising of the discount rate to 1 3/4% in April. Margin requirements were again raised, to 70%.² Economic expansion increased in the summer of 1955, supported by rapid increases in mortgage and consumer credit. The Open Market Committee became concerned that prices, after being stable for two years, might break out on the upside due to pressure from costs and anticipation of price rises by businessmen and consumers. It was doubted that productivity could be increased fast enough to avert inflationary trends. In spite of these trends, the Federal Open Market Committee did not attempt to apply more than a mild restraint to the economy in the first half of 1955. The Committee felt that the Federal Reserve System must supply reserves to match the growth of the economy and that normal seasonal requirements in the last half of the year would be added to the demand for reserves. In addition, Treasury financing in the third quar-

¹Forty-Second Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1955 (Washington: Board of Governors of the Federal Reserve System, 1956), p. 90.

²Ibid., pp. 95-6.

ter of 1955 would require reserves to assure bank participation in the initial distribution of new issues.

In its meeting of August 2, 1955, the Open Market Committee changed its directive for conducting open market operations by providing that transactions be with a view "to restraining inflationary developments in the interest of sustainable economic growth." This move to greater restraint was taken in view of the strong expansion that had taken place. The Committee felt that many industries were operating at near-capacity levels and easy bank credit would cause an increase in prices rather than production. As a move to greater restraint, discount rates were raised in a series of steps from $1\frac{3}{4}\%$ to $2\frac{1}{2}\%$ during August and September.¹

A situation arose in November of 1955 which caused the Open Market Committee to temporarily abandon its policy against purchasing Treasury securities on a when-issued basis. The Treasury announced an offering of \$12 billion in refunding securities at $2\frac{5}{8}\%$. From the response, it was evident that much of the maturing issue would be redeemed for cash and the Treasury would have difficulty in selling the new issue. The Secretary of Treasury requested that the Federal Reserve System purchase some of the new issue to prevent a possible deterioration of the whole securities market. The Open Market Committee granted the request, authorizing purchase of \$400 million of the certificates and actually purchasing \$167 million.²

Federal Open Market Committee

¹Ibid., pp. 101-6.

²Ibid., pp. 108-10.

The year of 1956 was one of uncertainty as to whether a turning point would be reached in the expansion which began in 1954. While demand for credit remained generally strong throughout the year and prices continued to creep upward, changes in consumer spending presented the Board of Governors with the problem of whether to make a shift in the credit policy it had been pursuing.

The authority for the Federal Reserve Bank of New York¹ to conduct transactions in the open market was reworded several times during 1956, reflecting the changing conditions appearing in the economy.

In the meeting of January 24, 1956, the directive to the Federal Reserve Bank of New York was modified by adding that transactions should take "into account any deflationary tendencies in the economy." This phrase did not indicate that a shift in credit policy had occurred, but rather a preparation to shift policy if the peak of the boom was reached in the near future. The Committee decided, however, that no change in the degree of restraint should be made at that time.

By the time of the meeting of March 27, 1956, the turning point had not been reached; instead, the economy was moving on a plateau. The Committee judged that the next move would be up rather than down. The following statement indicated the data studied to arrive at that decision.

Among the general factors leading to this conclusion were the

¹A change in procedure for conducting open market operations occurred on June 22, 1955. At that time the executive committee of the Federal Open Market Committee was abolished; directives were issued directly to the Federal Reserve Bank of New York which conducts the actual operations.

much greater than expected plans of business concerns in all major lines for plant and equipment expenditures, the widespread optimism of consumers as to the economic outlook and their own financial position and income prospects, and evidence of an exceptionally heavy demand for bank credit in the current month. The Committee also noted that common stock prices had risen sharply. Growing pressures for increases in prices and wages were evident, and there was danger that if supported by further credit expansion pressures would engender an inflationary spiral.¹

After reaching its conclusion, the Committee deleted the statement in the open market directive that transactions be conducted to take deflationary tendencies into account. This left the main purpose of open market transactions, "restraining inflationary developments in the interest of sustainable economic growth."²

With the belief that the next move in the economy would be up, the Federal Reserve Banks took steps to increase the degree of credit restraint. In April, 1956, ten of the Federal Reserve Banks raised their discount rates from 2½% to 2 3/4%. The Banks of Minneapolis and San Francisco raised their rates from 2½% to 3% the same month.³ In addition to increasing restraint, these actions brought discount rates into better alignment with short-term interest rates. They also served as a signal to businessmen that higher borrowing costs might be anticipated on future plant and equipment financing.⁴

In May of 1956, the Federal Open Market Committee restored the phrase in its directive to the Federal Reserve Bank of New York to take

¹Forty-Third Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1956 (Washington: Board of Governors of the Federal Reserve System, 1957), p. 26.

²Ibid., pp. 17-47. ³Ibid., p. 48. ⁴Ibid., p. 49.

"into account any deflationary tendencies in the economy." The main reason for adding the phrase was due to the lessening of consumer demand. Auto sales at the retail level had fallen and manufacturers were cutting production in order to reduce dealers' inventories, which had risen to 900,000 units. The use of consumer installment credit had slowed down in other areas also. In the capital markets, new issues for business expansion were meeting less ready reception and stock market prices were declining.¹

The restrictive policy had forced the banks to do heavy borrowing at the Federal Reserve Banks. Loans and discounts had risen to the highest level since early 1953. Businessmen and bankers were concerned as to whether credit would be available even at higher interest rates during the next few months. The Committee, therefore, decided to supply more reserves to the banks through open market operations. During the next two weeks, the Federal Reserve System supplied \$300 million in additional reserves.²

During June and July of 1956, the outlook for the economy brightened. Retail sales rose to near-record levels despite lower sales of automobiles. The gross national product had risen and personal income was at a new high. The steel strike had little effect on the economy due to inventory buildups by users. With the upward pressure on the economy, the Open Market Committee deleted the phrase in its directive relating to deflationary tendencies.³

¹Ibid., pp. 29-30. ²Ibid., p. 30. ³Ibid., p. 31.

As the economy became increasingly optimistic, prices began to rise. In an attempt to halt this inflationary trend, the ten other Federal Reserve Banks raised their discount rates to 3%, the level of Minneapolis and San Francisco.¹ This action seemed to have little effect in the money markets. Demand for credit remained strong, and additional reserves were supplied to meet seasonal needs.²

In the fall of 1956, the credit restraint policy had a stronger effect on the economy. The growth in bank credit had subsided due to the restraint policy and the drop in liquidity caused by bank support of the expansion since 1954. The demand for funds remained strong, however, with a large number of new issues offered and being prepared to be offered. This tightening in the capital markets created a problem for the Treasury refunding operations. To relieve the pressure, the Open Market Committee changed the directive to the Federal Reserve Bank of New York by adding the phrase "that in carrying on such a program recognition should be given to additional pressures in the money, credit, and capital markets resulting from seasonal factors and international conditions," and began to make heavy open market purchases.³ These purchases enabled the banks to get nearly out of debt to the Federal Reserve System. On December 31, 1956, bank borrowings exceeded excess reserves by only \$80 million as compared with \$745 million on April 30.⁴

¹Ibid., pp. 50-1.

³Ibid., pp. 41-6.

²Ibid., p. 41.

⁴Ibid., p. 85.

In the early part of 1957, the economy continued to operate at high levels. Demand for credit was strong due to businessmen borrowing for year-end financial needs. In the first meeting of the new year, the Open Market Committee reversed the policy of temporarily easing reserve positions which had been followed in the last weeks of 1956. The directive to the Federal Reserve Bank of New York was changed to provide for open market operations with a view "to restraining inflationary developments in the interest of sustainable economic growth while recognizing unsettled conditions in the money, credit, and capital markets and in the international situation."¹ This restored the credit policy to one of restraint and in accordance with the revised policy, two billion dollars of securities were sold in the open market during January and February to increase pressure on reserve positions.²

During the first quarter of 1957, there was renewed apprehension among the members of the Open Market Committee that the expansion in the economy was about to end. In its meeting of January 28, 1957, the Committee noted:

There were at the same time developments that suggested that the economy might be losing some of its upward momentum. While these data were not sufficient to support a forecast of a downturn as a clear nearby prospect, they suggested that the economy might be entering a period of sidewise movement. For example, a tendency for total capital expenditures to level off was evidenced by recent figures for factory construction contracts, new machine tool orders,

¹Forty-Fourth Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1957 (Washington: Board of Governors of the Federal Reserve System, 1958), pp. 34-5.

²Ibid., p. 97.

and freight car orders, together with scattered announcements of postponements of plant construction projects. There were cross currents in the area of prices with higher costs showing up in increased prices for finished goods, both at wholesale and at retail, in contrast with a softening trend in prices of a number of primary products.¹

At its next meeting three weeks later, the Committee stated:

There was no clear evidence of serious weakness in the economy, although business and financial observers had been reappraising, with some doubts, their year-end expectations that 1957 would bring further advances in business activity and further creeping inflation.²

The problem facing the Committee of continuing inflation in view of a possible downturn in the economy is shown by its statement of March 26, 1957.

Although it appeared at this time that the boom had lost much of its buoyancy, it was not possible to tell whether the present side-wise movement would continue for some months, perhaps with a renewed upward movement, or whether the economy would decline. Consumer demand, industrial production, and employment remained at or near record levels, although they were no longer rising appreciably.³

In spite of these statements, the Committee felt that although there were definite indications of slowing down of expansionary forces in many sectors of the economy, a definite downturn had not begun. Since the downturn had not occurred, the Committee chose to resume the restraint that had been in effect throughout the major portion of 1956. They did make one concession to the possibility of a downturn occurring in the near future by adding to the open market directive the phrase "while recognizing uncertainties in the business outlook, the financial markets,

¹Ibid., p. 97.

²Ibid., p. 39.

³Ibid., p. 44.

and the international situation.¹

Another consideration involved in the decision to maintain restraint was the upcoming Treasury funding operations. While normally the Treasury decreases its debt in the first half of the year, in 1957 it was forced to go into the short-term market for new funds. While at the time there was an apparent slackening in demand for private credit, the Committee wanted to absorb these surplus funds through open market operations rather than let the Treasury borrow the surplus, which would be inflationary. The Committee preferred that the funds for the Treasury should come from private savings or a curtailment in private loans.²

By June of 1957, over-all economic activity was showing great strength. Manufacturer's new orders had risen, and the average hours worked in manufacturing had increased. Outlays for residential construction were up, together with a rise in construction costs. Consumer prices had risen 4% over the previous year. There was widespread belief that the pattern of the economy in 1957 would be similar to that of 1956; a sidewise movement with easing tendencies through July, followed by a strong expansion later in the year.³

During the meeting of July 9, 1957, there was some discussion for increasing the degree of credit restraint. This was in view of the fact that seasonal reserves would shortly be needed and the Treasury would soon be coming into the market. It was suggested that the flow of reserves be increased while simultaneously raising discount rates. This

¹Ibid., p. 42.

²Ibid., pp. 42-3.

³Ibid., pp. 47-8.

would act as a signal that the Federal Reserve System was tightening its credit policy while supplying the necessary reserves. It was concluded that taking the two divergent steps would be an unwise move. Finally, the Committee decided to maintain the degree of pressure that had been exerted on reserve positions.¹

In August, 1957, the Federal Reserve Banks raised their discount rates to 3½%. These changes had the intent of bringing discount rates more in line with general interest rates rather than increasing the degree of credit restraint. In early August, commercial banks had raised their prime interest rates from 4% to 4½%, which caused the Board of Governors to approve the higher discount rates.²

By the time of the October 1, 1957 meeting, there was considerable belief that expansion was at an end and the next move of the economy would be down. Cautiousness was reflected in business inventory policy which held inventories in close relationship to sales. Inflationary pressures seemed to be lessening, although the Committee felt that the possibility of further inflation had not ended. Interest rates had leveled out since August, and business loans showed a sharp decline in September. However, heavy borrowing by large corporations and the Treasury through bond issues continued. The decision of the Committee at this meeting was that there should be no change in credit policy.³

Three weeks later the Committee received more evidence of business pessimism. The economic data presented did not cause the Committee

¹Ibid. ²Ibid., p. 68. ³Ibid., pp. 51-2.

to change its policy, although the members agreed the situation should be watched closely in order to make changes that might become necessary. The open market directive was renewed without change, although it was agreed that operations should tend to the easier side.¹

V. CREDIT EASE, NOVEMBER 1957 TO AUGUST 1958

On November 12, 1957, the Federal Reserve System shifted its credit policy away from restraint. The Open Market Committee reworded its directive to the Federal Reserve Bank of New York by calling for operations with a view "to fostering sustainable growth in the economy without inflation, by moderating the pressures on bank reserves." Economic indicators presented during previous meetings had shown that a widespread downturn in the economy was a distinct possibility. At the November meeting, the data presented showed that the economy was in the process of change, with expansive forces easing and contractive forces becoming more prominent. Declines had taken place during October in industrial production, employment, and department store sales. Private demand for bank credit had eased considerably, countering the usual seasonal increase normal for that time of year. Bank reserve positions had eased somewhat reflecting a decline in required reserves and open market operations tending towards the easier side.

At the November meeting, there was no doubt that the downturn was under way. The question was how long the decline would continue, in

¹Ibid., pp. 53-4.

what degree, and what changes should be made in credit policy to compensate for the decline. The Committee decided not to eliminate completely the restraint on credit expansion, but to moderately relax the degree of restrictive pressure.¹

In mid-November 1957, the Board of Governors approved lowering of Reserve Bank discount rates from $3\frac{1}{2}\%$ to 3% . This action was voted over the objections of Governor Robertson who felt that the prevailing economic situation did not call for a step which could be interpreted as a drastic move toward monetary ease. It was his opinion that the downturn was a readjustment from the previous upward movement and the dangers of continued inflation were as great as the danger of deflation.²

During November and early December, the economy continued to decline. Estimates placed the November index of industrial production at 139, a drop of 5 points since September. Automobile production schedules were reduced due to lack of sales. Business inventories were being liquidated at a high rate, particularly in the durable goods lines. In the financial area, considerable tightness was developing due to seasonal needs and Treasury financing, in spite of the additional reserves supplied by open market operations. The Committee decided, therefore, to supply additional reserves to the banks. The directive to the Federal Reserve Bank of New York was changed to provide for conducting open market operations with a view "to cushioning adjustments and mitigating recessionary tendencies in the economy." The reason for

¹Ibid., pp. 55-6.

²Ibid., p. 70.

the particular wording was to serve notice that the Federal Reserve System recognized that the economy had encountered a recession and credit policy was being changed accordingly.¹

As the economy continued to decline in the first part of 1958, the Federal Reserve System continued its policy of credit ease. Margin requirements were lowered in January from 70% to 50%. In doing so, the Board of Governors noted that common stock prices had been moving in a narrow range for several months, and yields were below those on high-grade corporate bonds. In making the reduction, the Board felt that potential excessive speculative activity and potential undue use of credit to finance such activity was not a danger at the time.²

Discount rates were lowered three times during the first half of 1958. From January 4, 1958 to February 14, 1958, discount rates at all Federal Reserve Banks except San Francisco were lowered from 3% to 2 3/4%. On March 6, 1958, the Board of Governors approved reductions in all Reserve Banks to 2 1/4%. In April and May, the discount rates were further reduced to 1 3/4%.³

Reserve requirements for member banks were also reduced three times in the first half of 1958. On February 19, the Board of Governors reduced requirements 1/2 of 1% for all classes of banks. This released

¹Ibid., pp. 60-1.

²Forty-Fifth Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1958 (Washington: Board of Governors of the Federal Reserve System, 1959), p. 72.

³Ibid., pp. 73-80.

approximately \$500 million from member bank required reserves. In March, requirements for all member banks were again cut $\frac{1}{2}$ of 1%, releasing an additional \$490 million of required reserves. In April the third reduction took place. In this cut, requirements for central reserve city banks were reduced in two stages, from 19% to 18 $\frac{1}{2}$ % and to 18% one week later. Reserve city bank requirements were also dropped from 17% to 16 $\frac{1}{2}$ %. Country bank requirements were not changed from the 11% requirement then in effect. The last changes released \$450 million in bank reserves.¹

Open market operations were conducted to continue easing reserve positions during the first half of 1958. During January only \$900 million in Government securities were sold to absorb reserves created by the seasonal return of currency to the banks after Christmas. On March 4, the open market directive was changed to provide for transactions with a view "to contributing further by monetary ease to resumption of stable growth of the economy." Open market purchases continued under the new directive; \$450 million in securities were purchased from February to mid-April.²

Altogether, from the end of November to the end of April, the Federal Reserve System provided over \$300 million of reserves through open market operations and released nearly \$1.5 billion through reductions in reserve requirements. An additional \$900 million of reserves were freed through a reduction in currency in circulation. Of this total,

¹Ibid., pp. 75-9.

²Ibid., pp. 30-41.

the banks lost nearly \$700 million due to foreign accounts drawing down balances in order to acquire gold. The banks also lost \$500 million of reserves through variations in float and other factors. On balance, however, the banks gained about \$1.5 billion of reserves. The banks used the \$1.5 billion in three ways. First, they reduced their borrowing at the Federal Reserve Banks about \$650 million to an average of around \$100 million. Secondly, they added \$200 million to their excess reserves. The remaining \$550 million became required reserves as it was used to finance a monetary expansion.¹

The \$550 million addition to required reserves was used as a base for banks to expand their loans and investments by \$7 billion. This occurred at a time when seasonal contraction usually takes place.² The monetary expansion was at a time when businesses were repaying bank loans due to inventory reductions, and caused banks to increase greatly their holdings of Government securities. The increase in available funds also permitted an increase in mortgage loans, which encouraged an expansion in residential construction activity. Local and State governments were able to borrow at attractive interest rates.³

One of the most important effects of the monetary expansion was

¹Thomas Woodlief, "Credit Developments and Monetary Policy in Recession" (Address given before the Management Conference of the Savings Association League of New York State, Washington D. C., May 7, 1958).

²Ibid.

³Forty-Fifth Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1958, op. cit., pp. 4-6.

the lowering of interest rates. Bond prices began to increase and were bid up further by speculators who expected more business recessions, continued credit ease, and higher bond prices.¹ Yields on Treasury bills dropped below $3/4$ of 1%; yields on long-term Government bonds fell almost to 3%. Yields on corporate bonds also dropped sharply.²

In May, there were indications that the recession might be leveling off. Inventory liquidation appeared to be slowing down while retail sales, personal income, and residential construction activity seemed to have stopped receding or to have risen slightly. By June, there were more indications that the economy was leveling off. The Open Market Committee, however, decided to continue its policy of ease until the trend was more certain. In making its decision, the Committee noted that reserves would be needed to cover payments for dividends, taxes and Treasury securities just offered, as well as to cover seasonal requirements of the July 4 holiday.³

At the end of June, severe pressure developed in the Government bond market. Speculators had bought heavily on thin margins in anticipation of higher prices. Due to temporary tightness in the money markets at the time when the speculators attempted to close out their commitments, a severe break occurred in bond prices. In addition, a great deal of forced selling took place as the thin margins disappeared with falling prices.⁴

¹Ibid., p. 6.

³Ibid., pp. 48-51.

²Ibid., p. 20.

⁴Ibid., pp. 7, 53.

Government bond prices continued to decline under selling ^{open} pressure in spite of the Federal Reserve System's action in supplying \$1.4 billion in reserve funds. In an attempt to stabilize prices, the Treasury entered the market and bought \$600 million in bonds between June 19 and July 9. About three-fourths of these bonds were retired with the remainder placed in Treasury investment accounts.¹

On July 18, the Federal Open Market Committee authorized the Federal Reserve Bank of New York to purchase up to \$50 million of Government securities that same day for the purpose of steadying the market. The New York bank was also given authority to purchase without limitation Government securities in addition to short-term issues. This authority was in keeping with the general policy which permitted the correction of disorderly conditions in the Government securities market. In an attempt to restore confidence, the Committee also publicly released the following statement:

In view of conditions in the United States Government securities market, the Federal Open Market Committee has instructed the Manager of the Open Market Account to purchase Government securities in addition to short-term Government securities.²

Under the authority, the Federal Reserve System purchased \$1.2 billion of securities involved in a Treasury refinancing, mostly on a "when-issued" basis.³

The authority to purchase long-term bonds was ended on July 24,

¹Ibid., p. 7.

²Ibid., pp. 53-55.

³Ibid., p. 7.

1958. On July 29, the policy directive was changed to provide for open market operations with a view to recapturing redundant reserves. This step was taken to absorb the funds that would be released when the Federal Reserve System paid for the securities purchased on a "when-issued" basis. This authority was continued until August 19, when Federal Reserve policy returned to a more normal role.¹

VI. CREDIT RESTRAINT, AUGUST 1958 TO DECEMBER 1959

As the recession of 1957-58 ended in the summer of 1958, the Federal Reserve System took prompt action to shift its policy of ease to one of restraint. On August 4, following a rise in common stock prices which had dropped stock yields below bond yields of the same companies and which was accompanied by a sharp increase in the volume of stock market credit, the Board of Governors raised margin requirements to 70%. On August 14, this action was followed by approval of a rise in discount rates to 2% at all Federal Reserve Banks.²

On August 19, the Federal Open Market Committee changed its open market directive to provide for transactions with a view "to fostering conditions in the money market conducive to balanced economic recovery." In taking this step toward restraint, the Committee noted that a vigorous revival in domestic economic activity was taking place. The index of industrial production had risen seven points from April through July. Regional reports indicated the recovery was widespread, although some

¹Ibid., pp. 56-9.

²Ibid., pp. 81-2.

areas still had large numbers of unemployed persons.

In considering the policy change, the Committee noted that a large Federal deficit would have to be financed during a period when the revival was taking place. The emergence of an inflationary psychology evidenced in the stock market could easily spread into the commodity and real estate markets. The Committee felt that the System could move in the direction of lower free reserves without seriously affecting the Government securities market.¹

During the last quarter of 1958, the economy continued to expand. Open market policy continued to exercise a mild degree of restraint to credit expansion. The prices of Treasury bonds stopped declining and new offerings were received without much strain in the market. In the stock market, activity continued strong and margin requirements were raised to 90% in October. Discount rates were raised to 2½% to bring them closer to open market rates.²

In December, the open market policy directive was changed to provide that transactions be conducted with a view "to fostering conditions in the money market conducive to sustainable economic growth and stability."³ In connection with this action, the Federal Reserve System refrained from supplying enough reserves to support the seasonal expansion and the banks were forced to borrow around \$100 million from the Federal Reserve Banks.⁴

¹Ibid., pp. 61-8.

²Ibid., pp. 62-8.

³Ibid., pp. 67-9.

⁴Ibid., p. 119.

The year of 1959 was one of continued recovery and expansion. It was marked with a credit expansion of \$60 billion, a new record for a peacetime year. Mortgage debt increased \$19 billion while consumer installment credit rose \$6.5 billion.¹ Bank loans increased \$12 billion; however, \$8 billion of the increase was due to selling of Government securities. The remaining \$4 billion loaned by the banking system was due to an increase in bank credit.²

The increase in bank credit was caused by an expansion of \$600 million in reserves supplied by Federal Reserve operations. Half of this \$600 million was due to an increase in Federal Reserve credit, while the other \$300 million was supplied by allowing banks to include some of their vault cash as required reserves.³

As the year progressed, one change was made in the open market policy directive. On May 26, the directive was revised to provide for operations with a view "to restraining inflationary credit expansion in order to foster sustainable economic growth and expanding employment opportunities." Although this was the only change in the language of the directive, there were times during the year when the directive was issued with the understanding that the conduct of operations would be

¹Perspective on 1959 (New York: Federal Reserve Bank of New York, 1960), pp. 7-8.

²Ibid., p. 8.

³Forty-Sixth Annual Report of the Board of Governors of the Federal Reserve System Covering Operations for the Year 1959, op. cit., pp. 3-5.

leaning on the side of restraint or ease.¹

During the year of 1959, discount rates were raised three times. On March 5, the Board of Governors approved new rates of 3% for all banks. On May 28, following an increase in the prime rate from 4% to 4½% by large city banks, discount rates were raised to 3½%. Following that increase, interest rates in general continued to rise reflecting the continuing strong demand for credit. From a rate of 3% in early August, Treasury bill yields rose to 4% in early September. In September, the prime rates for large banks rose to 5%. At that time, the Federal Reserve Banks raised their discount rates to 4% to put them closer to market rates of interest.²

¹Ibid., p. 64.

²Ibid., pp. 66-80.

CHAPTER IV

SUMMARY AND CONCLUSIONS

The purpose of the study was to determine (1) the criteria for the credit policy of the Federal Reserve System; (2) the means by which the credit policy is implemented; and (3) the actual credit policy in effect from 1951 to 1959. The purpose of this chapter is to present a summary of material contained in the study and to present the conclusions drawn from the study.

I. SUMMARY

The Federal Reserve System has for its objective facilitating stable economic growth in the United States. The means that the Federal Reserve System uses to carry out this objective are referred to as its credit policy.

In order to formulate credit policy, the Federal Reserve System has used several criteria as guides while others have been proposed. The first guide to credit policy was the reserve ratio, which is the ratio of gold assets to note and deposit liabilities. The use of this guide was intended to act in the same manner as the "automatic" gold standard. When gold entered the country, the money supply grew and credit became easier. When gold left the country, the money supply decreased and credit became tight. During the 1920's, a huge amount of gold entered and the reserve ratio reached such a high level that it

could no longer be used to guide contraction of credit.

With the abandonment of the reserve ratio, the Federal Reserve System used "maintenance of sound credit conditions" as a credit policy guide. This policy is based on the "real-bills" theory of banking. Under that theory, commercial banks granted loans only to finance the short-term needs of business and agriculture. By loaning only for these purposes, banks would supply funds only for productive uses. As the needs of business and agriculture increased, the money supply would also increase. This theory had practical limitations. Funds borrowed for working capital might be used for other purposes, and too much credit might be extended when goods are moving through different levels of distribution and loans extended at every level.

One criteria which has often been proposed but always rejected by the Federal Reserve System is that of price level stabilization. This standard is based on the quantity theory of money expressed in the formula $MV = PT$. Under this theory the Federal Reserve System would vary the amount of money M in order to keep the price level P constant. The objections to this guide to policy are:

- (1) Prices are only one element that should be constant.
- (2) The Federal Reserve System does not have complete control over the money supply.
- (3) The relationship between the supply of money and the price level is uncertain.
- (4) Price changes come too late in the sequence of events to provide time to act on them.

There are several different schools of thought which desire an interest rate guide to credit policy. The Treasury would like to have a low rate of interest in order to finance the public debt in a favorable climate. Another group, believing that we are in a stagnating economy with a lack of opportunity for investment unless savings can be obtained at extremely low interest rates, wishes to have perpetually low rates of interest. A third group advocates using interest rates as a method of monetary control; permitting rates to rise during an expansion in order to slow it down and forcing interest rates down in a recession to encourage recovery. Critics of this method point out the difficulties in stimulating borrowing even at low interest rates in a recession and preventing speculative uses of credit even at high rates in an expansion.

Another criteria for credit policy is that of maintaining full employment. The use of this guide is based on the Full Employment Act of 1946 in which Congress declared it was the responsibility of the Federal Government to maintain conditions for full employment. The Federal Reserve System has accepted this guide with the reservation that the stability of the dollar must also be maintained.

In order to carry out its credit policy, the Federal Reserve uses its credit control powers. These powers consist of two types; quantitative and qualitative. Quantitative controls seek to limit the amount of credit in the economy and act through bank reserves. They consist of reserve requirements, the discount rate, and open market operations. Qualitative controls seek to limit the purposes for which

credit is used.

Every member bank of the Federal Reserve System is required to keep on deposit at the Federal Reserve Bank of its district, funds equal to a percentage of its deposit liability. The amount of money equal to the percentage of its deposit liabilities are required reserves. Any amounts in its Reserve Bank account over required reserves are excess reserves, and may be safely loaned by a bank. Banks operate on a fractional reserve basis, and the banking system as a whole is able to loan several times the amount of the total excess reserves. In putting quantitative controls into effect, the Federal Reserve System acts against bank reserves. The action of the Federal Reserve System has a far-reaching effect, due to the fractional reserve situation. When expanding credit, an addition to reserves could be expanded in the form of loans by several times that amount. Similarly, a reduction in reserves means a bank must reduce its loans by several times the reduction.

One of the controls that the Federal Reserve System uses is its power to change reserve requirements, which is the power to change the percentage against deposits which must be kept at the Federal Reserve Bank. The Federal Reserve System employs this method when it wants to take broad action in releasing or absorbing reserves.

Banks are permitted to borrow funds at the Federal Reserve Banks. The rate of interest charged for these loans is known as the discount rate. Changes in the discount rate are made to encourage loans in a recession and discourage loans in an expansion. The discount rate also

serves as an index to the public of the Federal Reserve credit policy.

The third and most important quantitative control is the use of open market operations. In attempting to expand credit, the Federal Reserve System will buy Treasury securities in the open market. The check on the Federal Reserve Bank will be deposited by the seller in a commercial bank. The check will be returned to the Federal Reserve Bank and the commercial bank will have that amount credited to its reserve account. Similarly, in order to reduce reserves, the Federal Reserve System will sell securities in the open market. There are other factors, such as float, Treasury balances, foreign accounts, and currency in circulation which affect reserves. In practice, the Federal Reserve System takes these factors into account and then performs open market operations to achieve the desired amount of control.

The Federal Reserve System is permitted to regulate some of the purposes for which credit is granted. These qualitative controls include stock market margin requirements, consumer credit regulation, real estate credit control and voluntary credit restraint programs.

During the post-World War II period, the most serious problem in the economy was continuing inflation. This inflation was aided by the wide-spread use of bank credit. The Federal Reserve System was severely handicapped in dealing with the problem due to its policy of supporting the market in Government securities.

The Treasury and the Federal Reserve System reached an Accord on March 4, 1951, at which they reached agreement on several points concerning credit policy. The most important area of agreement was that the

Federal Reserve System would no longer support the Government securities market.

The period immediately following the Accord was one of expansion which continued until May of 1953. The Federal Reserve System conducted a credit policy of restraint during the period. Main reliance was placed on selective controls. Controls on consumer and real estate credit were instituted and then dropped. A voluntary credit restraint program was conducted for a time. Margin requirements were dropped to 50% near the end of the period.

The discount rate was changed only once from March, 1951 to May of 1953, a rise from $1\frac{3}{4}\%$ to 2%. Open market operations were complicated by lending support to the Treasury during refunding operations. Later in the period, the Federal Open Market Committee adopted a policy for conducting open market operations. The policy called for open market operations solely as a means of carrying out credit policy, and for confining operations to the short-term securities market.

The Federal Reserve System shifted its credit policy to ease in May of 1953. This policy continued until January of 1955. The shift in policy occurred when it was not clearly evident that the economy was in a recession. The Federal Reserve System acted promptly in easing bank reserves through a reduction in reserve requirements and strong open market operations. Discount rates were dropped twice during the period, from 2% to $1\frac{3}{4}\%$ and then to $1\frac{1}{2}\%$. Reserve requirements were dropped a second time on the occasion of a Treasury refinancing operation.

As the economy moved toward recovery, Federal Reserve credit

policy was shifted to one of restraint. This lasted from January, 1955 to November, 1957. In this period frequent use was made of discount rate changes, bringing the rates up to $3\frac{1}{2}\%$. Margin requirements were also raised in two steps, from 50% to 60% and then to 70%. Open market operations were conducted to keep the pressure on bank reserves, except on two occasions when the Federal Reserve System assisted in Treasury refunding operations. On one of these refinancing operations, the Board of Governors temporarily abandoned its standing policy not to purchase "when-issued" securities in order to prevent the failure of a security offering. During 1956 there was considerable uncertainty as to whether or not the expansion might be ending. Although the Open Market Committee did not change its policy directive, open market operations were conducted toward the easier side during short periods.

The Federal Reserve System shifted from restraint to ease in November, 1957, when it was apparent a recession was setting in. Margin requirements were cut from 70% to 50%. Frequent changes were made in the discount rate; there was a total drop from $3\frac{1}{2}\%$ to $1\frac{3}{4}\%$. Reserve requirements were reduced three times, freeing large amounts of reserves. These reserves were used to finance a strong monetary expansion, with banks adding strongly to their loan and investment accounts.

During this period a severe break occurred in the Government bond market. Speculators had bought heavily in a new Treasury issue on thin margins. When they were not able to finance their purchases, the market slumped and the slump spread to other issues. In that background, the Federal Reserve System began to purchase long-term securities in the

open market and an amount of "when-issued" securities at the next large offering, until the market had steadied. Open market activities were then directed to absorbing the reserves added by the purchases. By the time that was complete, recovery was well under way.

In August, 1958 credit policy was shifted from ease to restraint. Margin requirements were immediately raised from 50% to 70%. Discount rates were raised four times from $1\frac{3}{4}\%$ to 4% during the period August, 1958 to December, 1959. The year of 1959 experienced a rise in credit outstanding of \$60 billion. Due to the pressure on bank reserves through open market operations, banks supplied only \$4 billion of the total.

II. CONCLUSIONS

During the period under study, the economy moved through a long period of expansion which was interrupted by two short recessions. During that time the index of industrial production rose from 120 to 153. This indicates that the Federal Reserve System had at least some measure of success in its credit policy objective of economic growth. The growth, however, was not achieved without inflation.

The most important single event affecting credit policy from 1951 to 1959 was the Accord. With the reaching of the Accord it became possible for the Federal Reserve System to pursue a deflationary, as well as inflationary, credit policy. Although the Accord nominally made the Federal Reserve System independent of the Treasury, the Federal Reserve System gave support to Treasury financing programs by (1) releasing, or

not absorbing, reserves at the time of Treasury refunding; (2) entering into the long-term bond market in July, 1958 to stabilize security prices; (3) purchasing of "when-issued" securities to support Treasury refundings. Still the Accord gave the Federal Reserve System a freedom of action which was impossible to achieve while supporting bond prices.

Following the Accord, the Federal Reserve Board of Governors refrained for a time from making changes in the discount rate as part of its agreement. Thereafter the Board began to make more frequent changes, both as a control measure and to keep discount rates in line with market interest rates.

The Federal Reserve System used changes in reserve requirements as a control measure only during recessionary periods. The failure to raise requirements when the Federal Reserve System is pursuing a credit policy of restraint indicates the System desires that the commercial banks have greater expansion powers permanently from the reserve base.

The practical conduct of open market operations seemed to achieve the desired pressure on bank reserves, occasionally supplemented by reduction in reserve requirements. As pointed out in the study, open market operations must be conducted continuously in order to counterbalance the other factors affecting bank reserves.

In reaching a credit policy, the Federal Reserve System has looked at both physical and psychological factors affecting the economy. The System has not been guided by a single criterion, such as the price level, in arriving at a credit policy, but has been guided by many factors. Among these have been consumer demand and credit, construction

activity, gross national product, stock market activity and credit, and industrial production. Unemployment has been only one factor considered, even though the Employment Act of 1946 could have been interpreted to make unemployment the guiding consideration.

In regard to the timing of credit policy decisions, the Federal Reserve System acted after a turn in the economy had been established in every case except one. In 1953, the Federal Reserve System switched to a policy of ease before the trend had definitely been established, although the indicators showed a recession was probable. The decision made was correct as later data showed the development of a recession.

The policy of reversing credit policy only after a trend has been established prevents a "whipsaw" effect in making changes. If the Federal Reserve System had followed a course of reversing credit policy at initial indications of slump or boom, policy would have been changed several times during 1956, although the correct policy was one of continued restraint. The ability of the Federal Reserve System to rapidly collect data enables it to determine the trend shortly after it develops.

The use of Federal Reserve credit policy during the period 1951 to 1959 shows the existence of a powerful anti-cyclical weapon in the economy. The bold use of credit policy since the Accord indicates that the Federal Reserve System will continue to play a most important part in the economy.

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